F&V Capital Management, LLC
805 Third Avenue, 12th Floor
New York, NY 10022

H. Terrence Riley III, CFA
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Contact: Karin Mueller-Paris
+1(212) 326 9533 kmm@fvcm.us

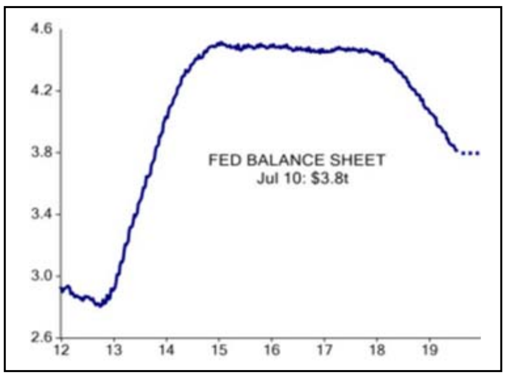
S&P 500

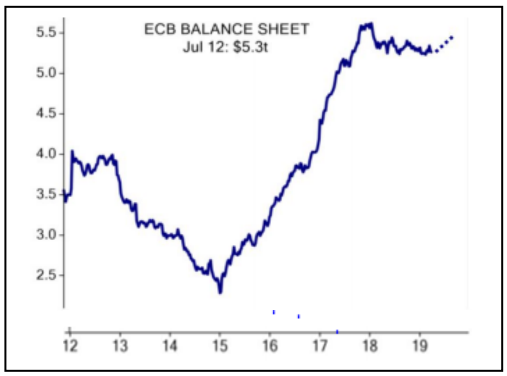
Equity Prices Continue Rebound as Growth Slows

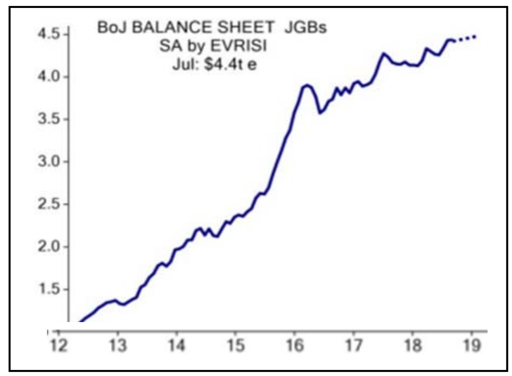
Stock prices performed as we expected in our report last April. Looking ahead, risk remains somewhat elevated, but equities should produce moderate returns through the end of 2019 thanks to friendly central banks. At the time of our last report, the S&P was showing indications of being over-bought and the 6.8% correction between April 30th and June 3rd was anticipated. But, also as expected, good business fundamentals and the Federal Reserve's intention to abort plans to further raise interest rates provided the fuel for higher stock prices thereafter. The U.S. treasury yield curve remains inverted, a classic warning of recession, but most other U.S. data remains positive. The current consensus expectation is that U.S. economic growth will slow to about a 2% rate for the second half of 2019 from the recent 3% rate. We agree with that expectation, but the risk of a global recession next year may be greater than generally appreciated. Accordingly, we have been reducing portfolio risk in recent months and may continue to do so if prices trend higher still.

Don’t Fight the Fed (or the ECB) is a Maxim We Still Follow

Looking forward at the next twelve months, it now appears that the Fed, the ECB and the Bank of Japan will add some $600 billion in liquidity through balance sheet expansion. Despite the very good growth the U.S. has experienced since mid-2017, Fed Chairman Powell has clearly gotten the sense that the U.S. is facing substantial risks which are being transmitted through global financial and trading mechanisms. In recent speeches, Powell has made clear that the Fed intends to cut the Fed Funds rate (the overnight bank lending rate) by at least 0.25% at the July 30-31 meeting. Furthermore, the Fed now appears committed to stabilize its assets in the months ahead following an extended period of quantitative tightening. A stable Fed balance sheet, combined with expectations that the Japanese central bank will continue to grow its balance sheet some 1.5 trillion Yen per month, while the ECB may expand its balance sheet by 30b Euros per month, translates into a global liquidity boost of about $600 billion (annual rate). It is rather difficult to be bearish on equities when there is such coordinated central bank easing taking place.

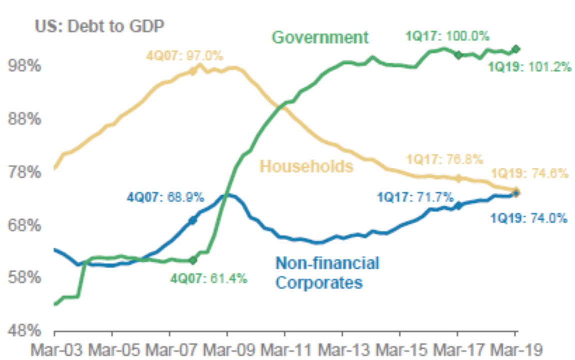


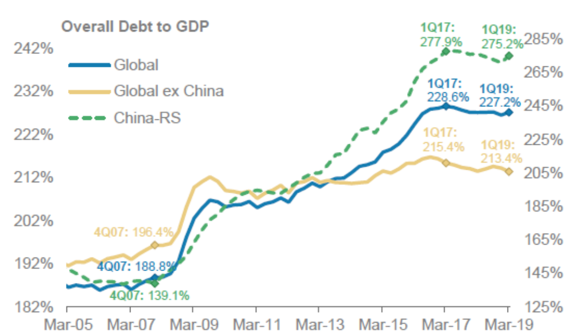




Source: Evercore ISI

The data for the U.S. have remained amazingly strong, but the alarm bells have been going off at the Fed for two reasons we think: 1. Much data from Europe, Japan and China have been sending warning signals; 2. The inverted yield curve in the U.S. is the market’s way of telling us something is wrong even if we’re not sure what it is. At the root of the issue, we think, is the significant expansion in global debt. As seen in the charts below, private U.S. household debt has been declining relative to GDP since the Great Recession, while government debt has soared. Overall, U.S. debt has been stable at about 250% of GDP. However, Euro area debt has risen from around 260% of GDP to near 300%, while Chinese debt has exploded from 140% to 275%, an astronomical increase for an emerging economy.





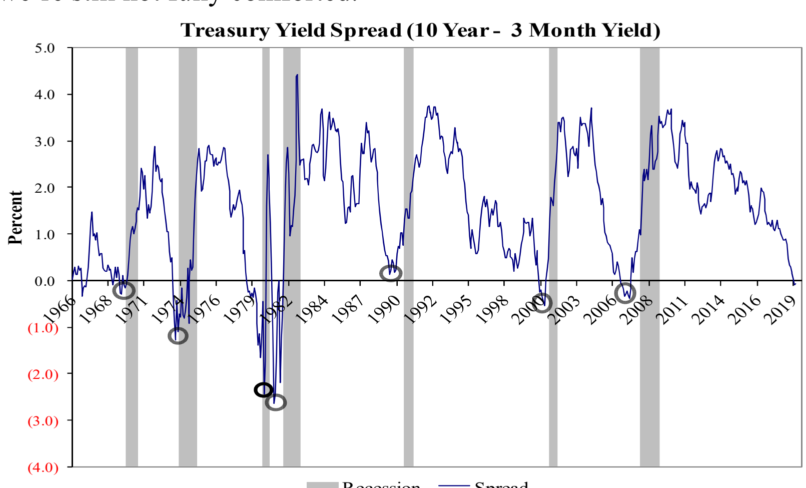
Source: Morgan Stanley

Intuitively, one may think that high global debt levels would translate into higher risk and, hence, higher interest rates. However, there is an argument why high debt drives interest rates downward. It is our opinion that taking on debt can be, in certain circumstances, analogous to eating a meal in a restaurant. At first, you are debt free and hungry so you begin to eat. Everything is great and you start to expand. However, at some point, you realize that, relative to your appetite and income, you've had enough. The interest that you owe to the restaurant is already high and you don't want anymore. But the restaurateur wants you to have more, so he keeps offering you more deserts and after dinner drinks, and he even tries to entice you to have more by offering you tiramisu at half price. It looks so great but you're getting to the point where you're stuffed. You've now unlatched your belt buckle and the restaurateur would have to PAY YOU to make you eat any more. That's were borrowers are relative to the banks and other financiers.

Typically, business recessions occur because of a confluence of factors, and the next time will likely be no different. High debt levels are something that can be lived with as long as other problems don't creep up. However, the U.S. now has a president who has drawn a line in the sand with regard to the way China has dealt with private foreign companies. We have heard stories where private U.S. corporations have made complaints to the U.S. Chamber of Commerce about Chinese laws and practices, such as requiring local Chinese businesses partners and technology transfers, so that they can do business in China. But, at the same time, these businesses do not want the Chinese to know they have been complaining for fear of retribution. Undoubtedly, German, Japanese and other businesses have had similar issues. It was decided by the Trump administration that individual companies could not resolve these problems and a central, government response was required to put an end to "unfair" trade practices. Tariffs were decided to be the weapon of choice, but repercussions were inevitable. The Chinese economy is under stress. The official Chinese GDP growth figures, which are still above a 6% annual rate, are not to be believed and not just because they are so absurdly stable. The data is evident in declining auto sales, imports and other segments of the economy.

The spillover effects of the Chinese slowdown are now apparent outside of China. In Japan, hours worked and wages have both been recently declining. Machine tool orders are down an astounding 42% from their 2018 peak and the rate of decline accelerated in June. Ominously, the Japanese economy is weakening even before a planned increase in their VAT tax next October. A recession there now seems almost certain. Though not as pronounced, there have also been signs of weakness in Europe, partly due to declining orders from China.

Reading the opinions of most economists now, one would think that a U.S. recession is years away. But the classic 3 month – 10 year U.S. Treasury yield curve (below) gives us pause. It is true that the yield curve has not been negative for long, and the spread has only been negative in the range of about 0-15 basis points. However, a negative yield curve has been sufficiently reliable that we should not ignore it. The markets tell a story. The argument now being forwarded is that the yield curve will turn positive again when the Fed starts cutting short term interest rates starting at the end of this month. While that is entirely possible, we're still not fully comforted.

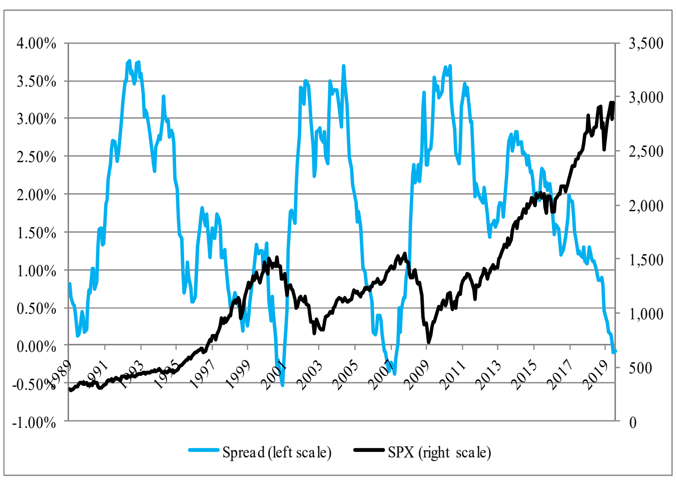


Source: Federal Reserve. FVCM

Two observations are clear from the past two business cycles: 1. The yield curve bottomed and started to turn positive very close to the cyclical peak in the S&P 500 (Chart 8); and, 2. The Federal Reserve started *reducing* the Fed Funds rate before the start of each of the past two recessions and very close to the cyclical peaks in the S&P 500 (Chart 9). These are good reasons not to be too comforted with the idea that Fed Funds cuts starting this month and a return to a positive yield curve will solve all matters. It is true that the Index of Leading Indicators in the U.S. is still nicely positive, as are the Purchasing Manager Indexes (PMI) for manufacturing and new orders. Furthermore, initial claims for unemployment are still near record lows and employers are still looking for more workers than they can find. Also, as already discussed, the balance sheets of U.S. households are in good shape and employment and wages are rising. However, the bond markets are a forward looking warning sign that suggest that risks are high.

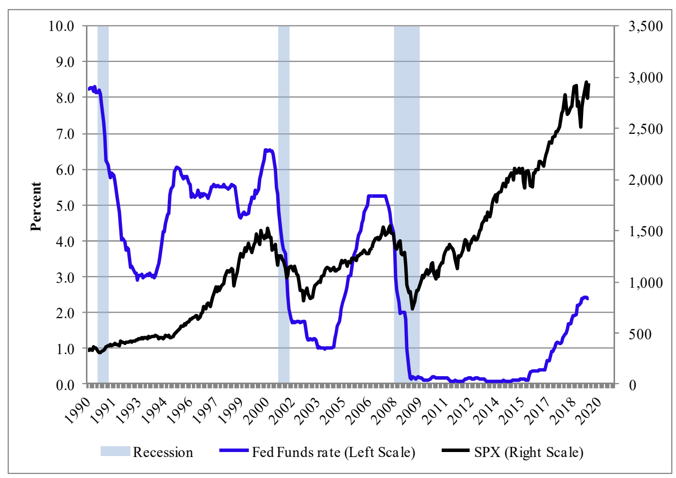
Investors should not be surprised to see stock prices propelled further upward in the months ahead thanks to central banks simultaneously easing monetary policy in the U.S., Europe and Japan, but data over the next two quarters will be important in determining likely market conditions in 2020. If there is a recession, we expect it to be shallow in the U.S. thanks to a very positive business environment from Washington, as well as due to the fact that there are no obvious excesses like there were in 2000 and 2007 when there were bubbles in tech stocks and the housing market, respectively. Now the bubbles look to be overseas, i.e, China. So we think a fair amount of capital should remain exposed to equities but with some defensive positioning as we wait for further data.

Chart 8 **Yield Curve vs. S&P 500**



Source: Factset, Federal Reserve, FVCM

Chart 9 **Fed Funds vs. S&P 500**



Source: Factset, Federal Reserve, FVCM
